

**Artesian Water Company, Inc.
(A Wholly Owned Subsidiary of
Artesian Resources Corporation)**

Financial Statements

Years Ended December 31, 2012 and 2011

The report accompanying these financial statements was issued by
BDO USA, LLP, a Delaware limited liability partnership and the U.S. member of
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Financial Statements

Years Ended December 31, 2012 and 2011

Artesian Water Company, Inc.

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Independent Auditor's Report

To the Board of Directors and Stockholder
Artesian Water Company, Inc.
Newark, Delaware

We have audited the accompanying financial statements of Artesian Water Company, Inc., which comprise the balance sheets as of December 31, 2012 and 2011, and the related statements of operations and retained earnings, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Artesian Water Company, Inc. as of December 31, 2012 and 2011, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

BDO USA, LLP

Bethesda, Maryland
April 18, 2013

Artesian Water Company, Inc.

Balance Sheets (In Thousands)

December 31,	2012	2011
ASSETS		
Utility Plant, at original cost (less accumulated depreciation 2012-\$81,069; 2011-\$74,849)	\$ 316,739	\$ 308,984
Current Assets		
Cash and cash equivalents	4	4
Accounts receivable (less allowance for doubtful accounts 2012-\$133; 2011-\$121)	4,241	3,306
Loan receivable from parent	12,115	10,988
Unbilled operating revenues	2,700	3,636
Materials and supplies - at cost on first-in first-out basis	1,344	1,472
Prepaid property taxes	1,322	1,287
Prepaid expenses and other	1,588	1,122
	23,314	21,815
Other Assets		
Non-utility property (less accumulated depreciation 2012-\$86; 2012-\$74)	258	183
Other deferred assets	4,664	4,560
	4,922	4,743
Regulatory Assets	1,122	1,436
	\$ 346,097	\$ 336,978
Liabilities and Capital		
Capitalization		
Common stock-\$1 par value (1,000 shares authorized, issued and outstanding)	\$ 1	\$ 1
Additional paid-in-capital	79,257	79,257
Retained earnings	24,116	21,641
Total stockholder's equity	103,374	100,899
Long-term debt, net of current portion	106,257	106,539
	209,631	207,438
Commitments and Contingencies		
Current Liabilities		
Current portion of long-term debt	1,111	1,137
Accounts payable	3,353	2,674
Accrued expenses	3,189	2,250
Overdraft payable	592	269
Payables - related party	927	234
Deferred income taxes	900	817
Accrued interest	1,125	1,207
Customer deposits	894	942
Other	1,546	1,549
	13,637	11,079
Deferred Credits and Other Liabilities		
Net advances for construction	12,359	14,027
Postretirement benefit obligation	374	455
Deferred investment tax credits	622	643
Utility plant retirement cost obligation	1,086	-
Deferred income taxes	44,050	41,262
	58,491	56,387
Net Contributions In Aid of Construction	64,338	62,074
	\$ 346,097	\$ 336,978

See accompanying summary of significant accounting policies and notes to financial statements.

Artesian Water Company, Inc.

Statements of Operations and Retained Earnings (In Thousands)

Year Ended December 31,	2012	2011
Operating Revenues		
Water sales	\$ 62,168	\$ 57,003
Other	1,487	1,642
	63,655	58,645
Operating Expenses		
Operation and maintenance expenses	31,257	30,317
Depreciation and amortization	7,371	6,886
Taxes		
State and federal income taxes		
Current	3,343	-
Deferred	2,871	4,631
Property and other	3,635	3,536
	48,477	45,370
Operating Income	15,178	13,275
Other Income, Net		
Allowance for funds used during construction (AFUDC)	266	112
Miscellaneous	798	521
Income Before Interest Charges	16,242	13,908
Interest Charges		
Long-term debt	6,747	6,786
Short-term debt	51	100
Amortization of debt expense	119	117
Other	2	5
	6,919	7,008
Net Income	9,323	6,900
Retained Earnings, beginning of year	21,641	20,912
Less: dividends to parent company	6,848	6,171
Retained Earnings, end of year	\$ 24,116	\$ 21,641

See accompanying summary of significant accounting policies and notes to financial statements.

Artesian Water Company, Inc.

Statements of Cash Flows (In Thousands)

Year Ended December 31,	2012	2011
Cash Flows From Operating Activities		
Net income	\$ 9,323	\$ 6,900
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,371	6,886
Deferred income taxes, net	2,850	4,546
AFUDC, equity portion	(169)	(66)
Changes in assets and liabilities:		
Accounts receivable, net of allowance for doubtful accounts	(565)	61
Unbilled operating revenues	936	(22)
Materials and supplies	128	(229)
Regulatory assets	314	(194)
Postretirement benefit obligation	(82)	(68)
Other deferred assets	(224)	(247)
Prepaid property taxes	(35)	(30)
Prepaid expenses and other	(466)	474
Accounts payable	679	(389)
Accrued expenses	939	272
Accrued interest	(82)	59
Customer deposits and other, net	(51)	87
Net cash provided by operating activities	20,866	18,040
Cash Flows From Investing Activities		
Capital expenditures (net of AFUDC, equity portion)	(14,576)	(11,702)
Proceeds from sales of assets	28	55
Net cash used in investing activities	(14,548)	(11,647)
Cash Flows From Financing Activities		
Net repayments under lines of credit agreements	-	(5,588)
Change in deferred debt issuance costs	119	91
Net borrowings (repayments) from parent company	693	(1,655)
Net issuance of loan to parent company	(1,127)	(10,988)
Capital contribution from parent company	-	15,641
Principal repayments of long-term debt	(1,037)	(964)
Issuance of long-term debt	729	3,195
Increase (decrease) in overdraft payable	323	(381)
Net advances and contributions in aid of construction	830	427
Dividends to parent company	(6,848)	(6,171)
Net cash used in financing activities	(6,318)	(6,393)
Net increase (decrease) in cash and cash equivalents	-	-
Cash and cash equivalents, Beginning of year	4	4
Cash and cash equivalents, End of year	\$ 4	\$ 4
Supplemental Disclosures of Cash Flow Information:		
Utility plant received as construction advances and contributions	\$ 22	\$ 154
Contractual amounts of contributions in aid of construction due from developers included in accounts receivable	\$ 370	\$ -
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the year for interest	\$ 6,997	\$ 6,914
Cash paid during the year for income taxes	\$ 63	\$ -

See accompanying summary of significant accounting policies and notes to financial statements.

Artesian Water Company, Inc.

Summary of Significant Accounting Policies

Basis of Accounting

Artesian Water Company, Inc., Artesian Water or the Company, is a wholly-owned subsidiary of Artesian Resources Corporation, or Artesian Resources. The Company provides water utility service to customers within its established service areas in Delaware, pursuant to rates filed with and approved by the Delaware Public Service Commission (the "DEPSC"). As of December 31, 2012, the Company served approximately 79,000 customers. The accounting records of the Company are maintained in accordance with the uniform system of accounts as prescribed by the DEPSC. The Company follows the provisions of the Financial Accounting Standards Board Accounting Standards Codification, or FASB ASC, Topic 980, which provides guidance for companies in regulated industries.

Reclassification

Certain accounts in the prior year financial statements have been reclassified for comparative purposes to conform with the presentation in the current year financial statements. These reclassifications had no effect on net income or stockholder's equity.

Utility Plant

All additions to plant are recorded at cost. Cost includes direct labor, materials, and indirect charges for such items as transportation, supervision, pension, and other fringe benefits related to employees engaged in construction activities. When depreciable units of utility plant are retired, the cost of retired property, together with any cost associated with retirement and less any salvage value or proceeds received, is charged to accumulated depreciation. In accordance with a DEPSC rate order issued on January 31, 2012, effective January 1, 2012, any cost associated with retirement, less any salvage value or proceeds received will be charged to a regulated retirement liability. This new approach resulted in an approximately \$1.2 million reclassification of utility plant to deferred credits and other liabilities on our Balance Sheet in our fiscal year 2012. Maintenance, repairs, and replacement of minor items of plant are charged to expense as incurred.

In accordance with a rate order issued by the DEPSC, Artesian Water accrues an Allowance for Funds Used During Construction or AFUDC. AFUDC, which represents the cost of funds devoted to construction projects through the date the project is placed in service, is capitalized as part of construction work in progress. The rate used for the AFUDC calculation is based on Artesian Water's weighted average cost of debt and the rate of return on equity authorized by the DEPSC. The rate used to capitalize AFUDC in 2012 and 2011 was 8.2%.

Artesian Water Company, Inc.

Summary of Significant Accounting Policies

Utility plant at December 31, comprised of:

<i>In thousands</i>	<i>Estimated Useful Life In Years</i>	<i>December 31, 2012</i>	<i>2011</i>
Utility plant at original cost			
Utility plant in service			
Intangible plant	-	\$ 140	\$ 140
Source of supply plant	45-85	16,872	16,458
Pumping and water treatment plant	8-62	60,796	56,435
Transmission and distribution plant			
Mains	81	184,762	180,724
Services	39	31,061	30,406
Storage tanks	76	21,158	21,131
Meters	26	19,960	19,699
Hydrants	60	10,242	10,056
General plant	3-31	46,178	44,540
Property held for future use	-	1,511	1,299
Construction work in progress	-	5,128	2,945
		397,808	383,833
Less - accumulated depreciation		81,069	74,849
		\$ 316,739	\$ 308,984

Depreciation and Amortization

For financial reporting purposes, depreciation is recorded using the straight-line method at rates based on estimated economic useful lives, which range from 3 to 85 years. Composite depreciation rates for water utility plant were 2.29% for 2012 and 2.22% for 2011. In a rate order issued by the DEPSC, the Company was directed effective January 1, 1998 to begin using revised depreciation rates for utility plant. In rate orders issued by the DEPSC, Artesian Water was directed effective May 28, 1991 and August 25, 1992 to offset depreciation recorded on utility plant by depreciation on utility property funded by Contributions in Aid of Construction, or CIAC, and Advances for Construction, or Advances, respectively. This reduction in depreciation expense is also applied to outstanding CIAC and Advances.

Utility Plant Retirement Cost Obligation

The utility plant retirement cost obligation consists of estimated costs related to the potential removal and replacement of facilities and equipment on the Company's water properties. Effective January 1, 2012, as authorized in the rate settlement discussed in Note 8 "Rate Proceedings," when depreciable units of utility plant are retired, any cost associated with retirement, less any salvage value or proceeds received is charged to a regulated retirement liability. Each year the liability is increased by an annual amount authorized by the DEPSC. Previously, when depreciable units of utility plant were retired, the cost of retired property, together with any cost associated with retirement less any salvage value or proceeds received, was charged to accumulated depreciation.

Artesian Water Company, Inc.

Summary of Significant Accounting Policies

Regulatory Assets

FASB ASC Topic 980 stipulates generally accepted accounting principles for companies whose rates are established by or are subject to approval by a third-party regulatory agency. Certain expenses are recoverable through rates charged to our customers, without a return on investment, and are deferred and amortized during future periods using various methods as permitted by the DEPSC. Depreciation and salary study expenses are amortized on a straight-line basis over a period of five years and two years for all other expenses related to Delaware rate proceedings and applications to increase rates. Artesian Water recognizes an offsetting regulatory asset with respect to its postretirement benefit obligation (see Note 5 to our Financial Statements for a description of the Company's Postretirement Benefit Plan). The deferred income taxes will be amortized over future years as the tax effects of temporary differences previously flowed through to the customers are reversed.

Regulatory assets at December 31, net of amortization, comprise:

<i>In thousands</i>	2012	2011
Postretirement benefit obligation	\$ 497	\$ 567
Deferred income taxes	491	506
Expense of rate and regulatory proceedings	134	363
	<u>\$ 1,122</u>	<u>\$ 1,436</u>

Impairment or Disposal of Long-Lived Assets

Our long-lived assets consist primarily of utility plant in service and regulatory assets. A review of our long-lived assets is performed in accordance with the requirements of FASB ASC Topic 360. In addition, the regulatory assets are reviewed for the continued application of FASB ASC Topic 360. The review determines whether there have been changes in circumstances or events that have occurred requiring adjustments to the carrying value of these assets. FASB ASC Topic 360 stipulates that adjustments to the carrying value of these assets would be made in instances where the inclusion in the rate-making process is unlikely.

Other Deferred Assets

Debt issuance costs are amortized over the term of the related debt, which range from 10 to 30 years. The investment in Co-Bank, which is a cooperative bank, is related to certain outstanding First Mortgage Bonds and is a required investment in the bank based on the underlying long term debt agreements.

Artesian Water Company, Inc.

Summary of Significant Accounting Policies

Other deferred assets at December 31, net of amortization, comprised:

<i>In thousands</i>	2012	2011
Debt issuance cost	\$ 2,108	\$ 2,228
Investment in Co-Bank	2,523	2,294
Other	33	38
	\$ 4,664	\$ 4,560

Advances for Construction

Water mains, services and hydrants, or cash advances to reimburse Artesian Water for its costs to construct water mains, services and hydrants are contributed to Artesian Water by customers, real estate developers and builders in order to extend water service to their properties. The value of these contributions is recorded as Advances for Construction. Artesian Water makes refunds on these advances over a specific period of time based on operating revenues generated by the specific plant or as new customers are connected to the mains. After all refunds are made within the contract period, any remaining balance is transferred to CIAC.

Contributions in Aid of Construction

CIAC includes the non-refundable portion of advances for construction and direct contributions of water mains, services and hydrants, or cash to reimburse for costs to construct water mains, services and hydrants.

Income Taxes

The Company is included in the consolidated tax returns of its parent, Artesian Resources Corporation. However, for financial statement purposes, the Company calculates its tax provision on a separate return basis.

Deferred income taxes are provided in accordance with FASB ASC Topic 740 on all differences between the tax basis of assets and liabilities and the amounts at which they are carried in the consolidated financial statements based on the enacted tax rates expected to be in effect when such temporary differences are expected to reverse. Under FASB ASC Topic 740, the Company analyzed its various tax positions and determined that no further entry, recognition or derecognition was required. The Company would recognize, if applicable, interest accrued and penalties related to unrecognized tax benefits in interest expense and in accordance with the regulations of the jurisdictions involved.

The Tax Reform Act of 1986 mandated that Advances and CIAC received subsequent to December 31, 1986, generally are taxable income. The 1996 Tax Act provided an exclusion from taxable income for CIAC and Advances received after June 12, 1996 except for certain contributions for large services that are not included in rate base for rate-making purposes.

Artesian Water Company, Inc.

Summary of Significant Accounting Policies

Investment tax credits were deferred through 1986 and are recognized as a reduction of deferred income tax expense over the estimated economic useful lives of the related assets.

Revenue Recognition and Unbilled Revenues

Water service revenue for financial statement purposes includes amounts billed to customers on a monthly basis. Water service revenues also include unbilled amounts based upon estimated usage from the date of the last meter reading to the end of the accounting period. As actual usage amounts are received, adjustments are made to the unbilled estimates in the next billing cycle based on the actual results.

Accounts Receivables

Accounts receivable are recorded at the invoiced amounts. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in our existing accounts receivable. The Company reviews the allowance for doubtful accounts on a quarterly basis. Account balances are written off against the allowance when it is probable the receivable will not be recovered. The allowance for doubtful accounts was \$133,000 at December 31, 2012 and \$121,000 at December 31, 2011. The corresponding expense for the year ended December 31, 2012 and 2011 was \$173,000 and \$253,000, respectively. The following table summarizes the changes in the Company's accounts receivable balance:

Receivables at December 31, comprised:

<i>In thousands</i>	2012	2011
Customer accounts receivable - water	\$ 3,970	\$ 3,353
Contractual amounts of contributions in aid of construction due from developers	370	-
Other	34	74
	4,374	3,427
Less allowance for doubtful accounts	133	121
Net accounts receivable	\$ 4,241	\$ 3,306

Artesian Water Company, Inc.

Summary of Significant Accounting Policies

The activities in the allowance for doubtful accounts are as follows:

Allowances at December 31, comprised:

<i>In thousands</i>		2012		2011
Beginning balance	\$	121	\$	124
Allowance adjustments		173		253
Recoveries		134		108
Write off of uncollectible accounts		(295)		(364)
Ending balance	\$	133	\$	121

Cash and Cash Equivalents

For purposes of the Statement of Cash Flows, the Company considers all temporary cash investments with an original maturity of three months or less to be cash equivalents. The Company utilizes its bank's zero balance account disbursement service to reduce the use of their lines of credit by funding checks as they are presented to the bank for payment rather than at issuance. If the checks currently outstanding, but not yet funded, exceed the cash balance on our books, the net liability is recorded as a current liability on the balance sheet in the Overdraft Payable account.

Use of Estimates in the Preparation of the Financial Statements

The financial statements were prepared in conformity with generally accepted accounting principles in the U.S., which require management to make estimates about the reported amounts of assets and liabilities including unbilled revenues, reserve for a portion of revenues received under temporary rates and regulatory asset recovery and contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from management's estimate.

Subsequent Events

Management has evaluated any events or transactions occurring after the balance sheet date through April 18, 2013, the date the financial statements were available to be issued, and noted that there have been no such events or transactions which would require adjustments to or disclosure in the Company's financial statements.

Artesian Water Company, Inc.

Notes to Financial Statements

1. Fair Value of Financial Instruments

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value.

Current Assets and Liabilities

For those current assets and liabilities that are considered financial instruments, the carrying amounts approximate fair value because of the short maturity of those instruments.

Long-term Financial Liabilities

All of the Company's outstanding long-term debt as of December 31, 2012 and December 31, 2011 was fixed-rate. The fair value of the Company's long-term debt is determined by discounting their future cash flows using current market interest rates on similar instruments with comparable maturities consistent with FASB ASC 825. Under the fair value hierarchy, the fair value of the long-term debt in the table below is classified as Level 2 measurements. The fair values for long-term debt differ from the carrying values primarily due to interest rates that differ from the current market interest rates. The carrying amount and fair value of the Company's long-term debt are shown below:

<i>In thousands</i>	December 31,	
	2012	2011
Carrying amount	\$ 107,368	\$ 107,676
Estimated fair value	\$ 133,818	\$ 127,337

The fair value of Advances for Construction cannot be reasonably estimated due to the inability to accurately estimate the timing and amounts of future refunds expected to be paid over the life of the contracts. Refund payments are based on the water sales to new customers in the particular development constructed. The fair value of Advances for Construction would be less than the carrying amount because these financial instruments are non-interest bearing.

2. Income Taxes

The difference between the effective tax rate (2012 - 40.0%; 2011 - 40.2%) and the amount derived by multiplying income before federal and state income taxes by the statutory federal income tax rate of 34% in 2012 and 2011 is primarily attributable to state income taxes, net of federal benefit.

As of December 31, 2012, the Company has fully utilized all of its federal net operating loss carry-forwards. As of December 31, 2012, the Company has state net operating loss carry-forwards ("NOL's") aggregating approximately \$767,000. These NOL's will expire if unused between 2028 and 2031. At December 31, 2012, for federal income tax purposes, there were alternative

Artesian Water Company, Inc.

Notes to Financial Statements

minimum tax credit carry-forwards aggregating approximately \$5,012,000 resulting from the payment of alternative minimum tax in current and prior years. These alternative minimum tax credit carry-forwards may be carried forward indefinitely to offset future regular federal income taxes. The Company has not recorded a valuation allowance for these tax carry-forwards, because the Company believes it is more likely than not that such benefits will be realized.

Under FASB ASC Topic 740, an uncertain tax position represents our expected treatment of a tax position taken, or planned to be taken in the future, that has not been reflected in measuring income tax expense for financial reporting purposes. As a result of our review of Artesian's tax positions, we determined that we had no material uncertain tax positions. The Company would recognize, if applicable, interest accrued and penalties related to unrecognized tax benefits in interest expense and in accordance with the regulations of the jurisdictions involved. There were no such interest and penalty charges for the period ended December 31, 2012 or December 31, 2011. The Company remains subject to examination by federal and state authorities for tax years 2009 through 2012.

Deferred income taxes are comprised of the following:

<i>In thousands</i>	December 31, 2012	2011
Alternative minimum tax and other credit carry forwards	\$ 5,031	\$ 3,688
Bad debt allowance	53	89
Federal and state NOL's	44	2,053
Other	450	355
Total deferred tax assets	5,578	6,185
Deferred tax liabilities related to:		
Property, plant and equipment basis differences	(49,327)	(47,013)
Expenses of rate proceedings	(53)	(144)
Property taxes	(525)	(512)
Regulatory asset	(195)	(201)
Other	(428)	(394)
Total deferred tax liabilities	(50,528)	(48,264)
Net deferred tax liability	\$ (44,950)	\$ (42,079)

Artesian Water Company, Inc.

Notes to Financial Statements

Deferred taxes, which are classified into a net current and non-current balance, are presented in the balance sheet as follows:

<i>In thousands</i>	December 31, 2012	2011
Current deferred tax liability	\$ (900)	\$ (817)
Non-current deferred tax liabilities	(44,050)	(41,262)
Net deferred tax liability	\$ (44,950)	\$ (42,079)

The provision for income taxes consisted of the following:

<i>In thousands</i>	December 31, 2012	2011
Current tax expense:		
Federal	\$3,343	\$ -
State	-	-
	3,343	-
Deferred tax expense:		
Federal	1,940	3,921
State	931	710
	2,871	4,631
Total provision	\$6,214	\$4,631

3. Lines of Credit

Artesian Water has a \$20 million line of credit with Co-Bank, ACB that allows for the financing of operations for Artesian Water, with up to \$10 million of this line available for the operations of its affiliate Artesian Water Maryland, Inc., which is also a wholly-owned subsidiary of Artesian Resources. The interest rate for borrowings under this line is the London Interbank Offered Rate, or LIBOR, plus 1.50%. The term of this line of credit expires on January 14, 2014.

Artesian Resources has a \$40 million line of credit with Citizens Bank, or Citizens, which is available to all subsidiaries of Artesian Resources. The interest rate for borrowings under this line is LIBOR plus 1.00%. This is a demand line of credit and therefore the financial institution may demand payment for any outstanding amounts at any time. The term of this line of credit expires on the earlier of May 30, 2013 or any date on which Citizens demands payment. As of December 31, 2012, Artesian Water did not have any borrowings under either of these lines of credit.

In 2011, Artesian Resources completed the sale of approximately 888,000 shares of its Class A Non-Voting Common Stock and used the net proceeds of approximately \$15.6 million (after deducting underwriting discounts and commissions and offering expenses) to fund a paid-in capital contribution in the same amount to Artesian Water. Artesian Water used the paid-in capital

Artesian Water Company, Inc.

Notes to Financial Statements

contribution to repay short-term borrowings (including borrowings incurred under our line of credit with Citizens that is available to all of Artesian Resources' subsidiaries).

These lines of credit, as well as both the long-term debt and the state revolving fund loans shown below, require us to abide by certain financial covenants and ratios. As of December 31, 2012, we were in compliance with these covenants.

4. Long-Term Debt

As of December 31, 2012 and 2011, substantially all of Artesian Water's utility plant was pledged as security for the First Mortgage Bonds. In addition, the trust indentures relating to these First Mortgage Bonds contain covenants which limit long-term debt, including the current portion thereof, to 66 2/3% of total capitalization including the current portion of the long-term debt, and which, in certain circumstances, could restrict the payment of cash dividends. As of December 31, 2012, however, no dividend restrictions were imposed under these covenants.

On July 15, 2011, Artesian Water entered into a Financing Agreement, with the Delaware Drinking Water State Revolving Fund, acting by and through the Delaware Department of Health & Social Services, Division of Public Health, a public agency of Delaware, or the Department. The Company has been given a loan of approximately \$3.6 million, or the Loan, from the Delaware Safe Drinking Water Revolving Fund to finance all or a portion of the cost to replace specific water transmission mains in service areas located in New Castle County, Delaware (collectively, the "Project"). In accordance with the Financing Agreement, the Company will from time to time request funds under the Loan as it incurs costs in connection with the Project. The Company shall pay to the Department, on the principal amount drawn down and outstanding from the date drawn, interest at a rate of 1.7% per annum and an administrative fee at the rate of 1.7% per annum. As of December 31, 2012, approximately \$1.5 million was borrowed under this Loan.

Artesian Water Company, Inc.

Notes to Financial Statements

<i>In thousands</i>	December 31, 2012	2011
First mortgage bonds		
Series O, 8.17%, due December 29, 2020	\$ 20,000	\$ 20,000
Series P, 6.58%, due January 31, 2018	25,000	25,000
Series Q, 4.75%, due December 1, 2043	15,400	15,400
Series R, 5.96%, due December 31, 2028	25,000	25,000
Series S, 6.73%, due December 31, 2033	12,600	13,200
	<u>98,000</u>	<u>98,600</u>
State revolving fund loans		
4.48%, due August 1, 2021	2,410	2,624
3.57%, due September 1, 2023.	940	1,010
3.64%, due May 1, 2025	1,570	1,667
3.41%, due February 1, 2031	2,936	2,993
3.40%, due July 1, 2032	1,512	782
	<u>9,368</u>	<u>9,076</u>
Sub-total	107,368	107,676
Less: current maturities	1,111	1,137
Total long-term debt	<u>\$ 106,257</u>	<u>\$ 106,539</u>

Payments of principal amounts due during the next five years and thereafter:

<i>In thousands</i>	2013	2014	2015	2016	2017	Thereafter
First Mortgage bonds	\$ 600	\$ 600	\$ 600	\$ 600	\$ 600	\$ 95,000
State revolving fund loans	511	587	611	635	660	6,364
Total payments	<u>\$ 1,111</u>	<u>\$ 1,187</u>	<u>\$ 1,211</u>	<u>\$ 1,235</u>	<u>\$ 1,260</u>	<u>\$ 101,364</u>

5. Employee Benefit Plans

401(k) Plan

Artesian Resources has a defined contribution 401(k) Salary Deduction Plan, or the 401(k) Plan, which covers substantially all employees of Artesian Water. Under the terms of the 401(k) Plan, the Company contributed 2% of eligible salaries and wages and matches employee contributions up to 6% of gross pay at a rate of 50%. The Company may, at its option, make additional contributions of up to 3% of eligible salaries and wages. No such additional contributions were made in 2012 and 2011. The 401(k) Plan expenses, which include Company contributions and administrative fees, for the years 2012 and 2011, were approximately \$736,000 and \$672,000, respectively.

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Supplemental Pension Plan

Effective October 1, 1994, Artesian Water established a Supplemental Pension Plan, or the Supplemental Plan, to provide additional retirement benefits to full-time employees hired prior to April 26, 1994. The Supplemental Plan is a defined contribution plan that enables employees to save for future retiree medical costs, which will be paid by employees. The Supplemental Plan accomplishes this objective by providing additional cash resources to employees upon a termination of employment or retirement, to meet the cost of future medical expenses. Artesian Water has established a contribution based upon each employee's years of service ranging from 2% to 6% of eligible salaries and wages. Artesian Water also provides additional benefits to individuals who were over age 50 as of January 1, 1994. These individuals are referred to as the "Transition Group." Effective November 1, 1994, individuals eligible for the Transition Group had the opportunity to defer compensation to the Supplemental Plan, and to receive a transition matching contribution for 5 years. Each one-dollar of eligible salaries and wages deferred by the Transition Group was matched with three, four, or five dollars by Artesian Water based on the employee's years of service subject to certain limitations under the federal tax rules. Plan expenses, which include Company contributions and administrative fees, for the years 2012 and 2011, were approximately \$266,000 and \$264,000, respectively.

Postretirement Benefit Plan

The Company has a Postretirement Benefit Plan, or the Benefit Plan, which provides medical and life insurance benefits to certain retired employees. Prior to the amendment of the Benefit Plan, substantially all employees could become eligible for these benefits if they reached retirement age while still working for Artesian Water. The amendment excludes any current employees from becoming eligible for these benefits upon retirement.

FASB ASC Topic 715 stipulates that Artesian Water accrue the expected cost of providing postretirement health care and life insurance benefits as employees render the services necessary to earn the benefits. Artesian Water recognizes an offsetting regulatory asset with respect to its post retirement liability. This asset is recorded based on the Delaware Public Service Commission, or DEPSC, order, which permits Artesian Water to continue recovery of postretirement health care and life insurance expense on a pay-as-you-go basis for the remaining eligible employees. Further, expense recovery as a percentage of rates is expected to remain generally constant over the initial years, and then decline until the obligation is liquidated. The amounts recognized in financial statements are determined based on an actuarial basis, which uses assumptions about inflation, mortality, medical trend rates and discount rates. A change in these assumptions could cause actual results to differ from those reported. Amounts charged to expense were approximately \$120,000 and \$112,000 for 2012 and 2011, respectively.

The Company uses December 31 as the measurement date to determine the postretirement benefit obligation. According to our actuarial report, the funded status of our defined benefit postretirement plan was calculated contemplating FASB ASC Topic 715 and the obligation is

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recorded at that amount. There was no other comprehensive income impact because we record a regulatory asset as provided by FASB ASC Topic 980. Additional disclosures required for our postretirement benefit obligation are presented below.

Benefit Obligations and Funded Status

<i>In thousands</i>	Year Ended December 31,	
	2012	2011
Change in Accumulated Postretirement Benefit Obligation		
Accumulated Postretirement Benefit Obligation at the Beginning of the Year	\$ 724	\$ 678
Interest Cost	30	35
Actuarial (Gain) or Loss	130	123
Benefits Paid	(125)	(117)
Plan Participant's Contributions	5	5
Accumulated Postretirement Benefit Obligation at the End of the Year	764	724
Change in Plan Assets		
Fair Value of Plan Assets at the Beginning of the Year	-	-
Benefits Paid	(125)	(117)
Employer Contributions	120	112
Plan Participant's Contributions	5	5
Fair Value of Assets at the End of the Year	-	-
Net Amount Recognized		
Funded Status	(764)	(723)
Unrecognized Transition Obligation Asset	9	17
Unrecognized Net Gain or Loss	258	139
Net Amount Recognized:	(497)	(567)
Amounts Recognized in the Balance Sheets		
Accrued Benefit Liability-Current	(123)	(112)
Accrued Benefit Liability-Noncurrent	(374)	(455)
Net Amount Recognized	\$ (497)	\$ (567)

<i>In thousands</i>	Year Ended December 31,	
	2012	2011
Weighted Average Assumptions at the End of the Year		
Discount Rate	4.00%	4.50%
Assumed Health Care Cost Trend Rates		
Health Care Cost Trend Rate Assumed for Next Year	6.00%	7.00%
Ultimate Rate	3.50%	3.50%
Year that the Ultimate Rate is Reached	2016	2016

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Impact of One Percentage Point in Assumed Health Care Cost Trend Rates

	Increase	Decrease
Effect on Service Cost & Interest Cost	\$ 1	\$ (1)
Effect on Postretirement Benefit Obligation	\$ 28	\$ (26)

Contributions

Artesian Water expects to contribute \$123,300 to its postretirement benefit plan in 2013. The following table represents the approximate annual benefits expected to be paid for the years ended December 31:

	(In thousands) Other Benefits
2013	\$ 123
2014	115
2015	105
2016	94
2017	83
2018 through 2022	271
	\$ 791

6. Commitments and Contingencies

Leases

In October 1997, Artesian Water entered into a 33-year operating lease for a parcel of land with improvements located in South Bethany, a municipality in Sussex County, Delaware. The annual lease payments increase each year by the most recent increase in the Consumer Price Index for Urban Workers, CPI-U, as published by the U.S. Department of Labor, Bureau of Labor Statistics. At each eleventh year of the lease term, the annual lease payment shall be determined based on the fair market value of the parcel of land. Rental payments for 2012 and 2011 were \$15,400 and \$15,300, respectively. The future minimum rental payment as disclosed in the following table is calculated using CPI-U as of October 31, 2012 as well as any adjustments for appraisals conducted to determine the fair market value of the parcel of land.

In November 2010, Artesian Water entered into a 5-year contract with Artesian Development Corporation, a subsidiary wholly owned by Artesian Resources, for office space located in Sussex County, Delaware. Rental payments for 2012 and 2011 were \$120,000 and \$110,000, respectively.

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Future minimum annual rental payments related to operating leases for the years subsequent to 2012 are as follows:

	(In thousands)
2013	\$ 136
2014	136
2015	116
2016	17
2017	17
2018 through 2030	225
	<u>\$ 647</u>

Interconnections

Artesian Water has one water service interconnection agreement with a neighboring utility, Chester Water Authority, which requires minimum annual purchases. Rates charged under this agreement are subject to change. Effective August 1, 1997, Artesian Water renegotiated the contract with the Chester Water Authority to, among other things, reduce the minimum purchase requirements from 1,459 million gallons to 1,095 million gallons annually, calculated as 3 million gallons per day times the number of calendar days in a year. The agreement is through the year 2021.

The minimum annual purchase commitments for all interconnection agreements for 2013 through 2017 and the aggregate total for the years 2018 through 2021, calculated at the noticed rates, are as follows:

	(In thousands)
2013	\$ 3,780
2014	3,780
2015	3,780
2016	3,791
2017	3,780
2018 through 2021	15,132
	<u>\$ 34,043</u>

Expenses for purchased water were approximately \$3,819,000 and \$3,809,000 for the years ended December 31, 2012 and 2011, respectively.

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Other Commitments

In 2005, Artesian Water entered into a 6-year agreement with Utility Service Co., Inc. to clean and paint tanks from 2006 to 2011 for \$1.9 million. In 2011, Artesian Water entered into a 2-year agreement with Southern Corrosion Inc. to clean and paint tanks in 2012 and 2013. Pursuant to the 2-year agreement, the expenditure committed for the years 2012 through 2013 is \$623,000. The tank painting expense for 2012 and 2011 was \$330,000, and \$344,000, respectively.

Budgeted mandatory utility plant expenditures, due to planned governmental highway projects, which require the relocation of Artesian Water's water service mains, expected to be incurred in 2013 through 2017 are as follows:

	(In thousands)
2013	\$ 660
2014	580
2015	430
2016	905
2017	1,455
	<u>\$ 4,030</u>

The exact timing and extent of these relocation projects is controlled primarily by the Delaware Department of Transportation.

Litigation

Artesian Water is subject to legal proceedings in the ordinary course of business. Any amounts from such legal proceedings that are probable and reasonably estimable are reflected in the financial statements.

On December 22, 2010, Artesian Water filed a complaint in the United States District Court for the Eastern District of Pennsylvania against Chester Water Authority claiming breach of contract, unjust enrichment and requesting declaratory judgment in relation to an agreement by Chester Water to supply bulk water supplies to Artesian Water. On February 11, 2011, Artesian Water received an answer and counterclaim from Chester Water Authority denying Artesian Water's claims and allegations, asserting a counterclaim for breach of contract and seeking monetary damages, related costs and attorneys' fees. Although Artesian Water intends to pursue its claims and defense in the action vigorously, there can be no assurances that it will prevail on any of the claims in the action, or, if it does prevail on one or more claims, of the amount or nature of recovery that may be awarded.

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Related to the ongoing litigation with Chester Water Authority, we have approximately \$2.2 million and \$1.1 million of accrued expenses recorded on our Balance Sheets as of December 31, 2012 and December 31, 2011, respectively. These accrued expenses represent the disputed portion of Chester Water Authority's rate increases and have been withheld from payments to Chester Water Authority pending the outcome of the litigation.

7. Related Party Transactions

Artesian Resources Corporation operates as the parent holding company of eight wholly-owned subsidiaries offering water, wastewater and engineering services on the Delmarva Peninsula. The subsidiaries include: Artesian Water, Artesian Water Pennsylvania, Inc., Artesian Water Maryland, Inc., Artesian Wastewater Management, Inc., Artesian Wastewater Maryland, Inc., each a regulated public utility, and three non-regulated subsidiaries; Artesian Utility Development, Inc., Artesian Development Corporation, and Artesian Consulting Engineers. Artesian Water has entered into transactions in the normal course of business with these subsidiaries.

For the years ended December 31, 2012 and December 31, 2011, Artesian Water had an intercompany loan receivable balance due from Artesian Resources Corporation of \$12.1 million and \$10.9 million, respectively, at an average interest rate of 1.2% and 1.3%, respectively. The corresponding interest income for the years ended December 31, 2012 and December 31, 2011 was \$139,000 and \$33,000, respectively. Artesian Water provides various administrative services to all other subsidiaries, and costs to perform these services are allocated accordingly, primarily based on a percentage of sales of each subsidiary. Artesian Water also has intercompany transactions for temporary federal income tax attributes. For the years ended December 31, 2012 and December 31, 2011, Artesian Water had an intercompany payable balance to the other subsidiaries of approximately \$927,000 and \$234,000, respectively. For the years ended December 31, 2012 and December 31, 2011, Artesian Water had intercompany water sales of approximately \$656,000 and \$364,000, respectively, to Artesian Water Maryland, Inc. for an interconnection between Delaware and Maryland. For the years ended 2012 and 2011, Artesian Water had intercompany rent expense of approximately \$120,000 and \$110,000, respectively, to Artesian Development Corporation for office space located in Sussex County, Delaware.

8. Rate Proceedings

Artesian Water, the DEPSC, and the Division of the Public Advocate entered into an agreement to settle Artesian Water's April 2011 application for an increase in rates. PSC Order No. 8097, issued on January 31, 2012, approved the settlement agreement, authorizing a permanent rate increase in revenue of approximately 11.13%, or \$6.25 million on an annualized basis. Since the permanent rate increase did not exceed amounts already collected under previously approved temporary increases in rates, Artesian Water was not required to refund any amounts to its customers. The approved permanent rate increase became effective January 1, 2012. The settlement also authorized a return on equity of 10%. Additionally, effective January 1, 2012, the settlement

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agreement permitted a tariff change that includes the use of a seasonal connection charge as well as a new approach for presenting the cost of retired property and ratemaking treatment for salvage costs to be recovered in rates. Previously, when depreciable units of utility plant were retired, the cost of retired property, together with any cost associated with retirement less any salvage value or proceeds received, was charged to accumulated depreciation. Under the settlement agreement, effective January 1, 2012, any cost associated with retirement less any salvage value or proceeds received is charged to a regulated retirement liability. This new approach resulted in an approximately \$1.2 million reclassification of accumulated depreciation of utility plant to deferred credits and other liabilities on our Balance Sheet as of December 31, 2012. The settlement also authorized Artesian Water to change from quarterly to monthly billing, which was implemented in April 2012.

Delaware law permits water utilities to put into effect, on a semi-annual basis, increases related to specific types of distribution system improvements through a Distribution System Improvement Charge, or DSIC. This charge may be implemented by water utilities between general rate increase applications that normally recognize changes in a water utility's overall financial position. The DSIC approval process is less costly when compared to the approval process for general rate increase requests. The DSIC rate applied between base rate filings is capped at 7.5% of the amount billed to customers under otherwise applicable rates and charges, and the DSIC rate increase applied cannot exceed 5% within any 12-month period. In 2011, the DEPSC approved a 1.47% DSIC rate that was effective January 1, 2011. For the year ended December 31, 2011, we earned approximately \$347,000 in DSIC revenue. In May 2012, Artesian Water filed an application with the DEPSC for approval to collect a 0.14% increase in the DSIC rate effective July 1, 2012. This increase was based on approximately \$486,000 in eligible plant improvements since the last rate increase. On June 19, 2012, the DEPSC approved the DSIC effective July 1, 2012, subject to audit at a later date. In November 2012, Artesian Water filed an application with the DEPSC for approval to collect a 1.45% increase in the DSIC rate effective January 1, 2013. This increase was based on approximately \$5.6 million in eligible plant improvements since the last rate increase. On December 14, 2012, the DEPSC approved the DSIC effective January 1, 2013, subject to audit at a later date. For the year ended December 31, 2012, we earned approximately \$42,000 in DSIC revenue.

9. Geographic Concentration of Customers

The Company provides water utility service to customers within its established service territory in all three counties of Delaware, pursuant to rates filed with and approved by the DEPSC. As of December 31, 2012, the Company was serving approximately 79,000 customers.



